STATE OF NEW HAMPSHIRE DEPARTMENT OF STATE

IN THE MATTER OF:))
Local Government Center, Inc.; Local Government Center Real Estate, Inc.; Local Government Center Health Trust, LLC; Local Government Center Property-Liability Trust, LLC;))))
Health Trust, Inc.; New Hampshire Municipal Association Property-Liability Trust, Inc.; LGC – HT, LLC; Local Government Center Workers' Compensation) Case No: C2011000036))
Trust, LLC; And the following individuals: Maura Carroll; Keith R. Burke; Stephen A. Moltenbrey; Paul G. Beecher; Robert A. Berry; Roderick MacDonald; Peter J. Curro; April D. Whittaker; Timothy J. Ruehr; Julia A. Griffin; and John Andrews))))
RESPONDENTS)))

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITIONER'S MOTION TO COMPEL, PRESERVE AND ENFORCE SUBPOENA

NOW COMES Petitioner, the Bureau of Securities Regulation (the "Bureau"), a part of the Corporations Division within the Department of State, and submits this Supplemental Memorandum in Support of Petitioner's Motion to Compel, Preserve and Enforce Subpoena dated November 18, 2011, and stating in support thereof the following:

I. Introduction

As part of the Bureau's Motion to Compel, Preserve and Enforce Subpoena dated November 18, 2011, the Bureau requested that the Hearing Officer enforce an outstanding investigatory subpoena and order an onsite inspection of the Local Government Center, Inc. and its affiliated entities listed above (hereinafter collectively referred to as the "LGC"). LGC

refuses to agree to an onsite inspection. Instead, LGC takes the position that the Bureau is precluded from issuing investigatory subpoenas and precluded from conducting an onsite examination after the initiation of the administrative proceeding, which began on September 2, 2011 with the filing of the Bureau's Staff Petition for Relief. LGC claims that the Bureau must use more "traditional" discovery methods of pre-trial discovery, such as interrogatories and depositions. This approach ignores the Bureau's broad investigatory and visitorial powers.

II. Violations of the New Hampshire Securities Act

In its Staff Petition for Relief dated September 2, 2011, the Bureau alleges several violations of the New Hampshire Securities Act, RSA § 421-B. The Bureau has alleged that LGC offered and sold, and are continuing to offer and sell, "risk pool" contracts, which are securities under RSA § 421-B:2(XX)(a) and unregistered securities in violation of RSA § 421-B:11. The Bureau further alleges that neither LGC nor its agents are licensed to sell securities as required by RSA § 421-B:6 and that LGC and its agents made untrue statements or omissions of material fact in connection with the offer, sale or purchase of securities, which is in violation of RSA § 421-B:6.

The Bureau is confident that the offer and sale of these "pool risk" contracts are to be considered "investment contracts" under RSA § 421-B:2(xx)(a). The language in RSA § 421-B:2(xx)(a) defines generally that "investment contracts" are considered securities under New Hampshire law. There are no New Hampshire state cases indicating the appropriate test for "investment contracts" under the present New Hampshire Securities Act, RSA § 421-B, but in the past the Bureau has adopted the well recognized test for investment contracts established in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) known as the "Howey Test". Under this well established test for "investment contracts," the Bureau is confident that LGC's practice of offering and selling "risk pool" contracts will be considered "investment contracts" under RSA § 421-B:2(xx)(a). In the alternative, the Bureau is confident that LGC's practice of offering and selling "risk pool" contracts will meet the alternative test for "investment contracts," known as the "risk capital test". See e.g. Silver Hills Country Club v. Sobieski, 361 P.2d 906 (1961).

Also worth noting, the federal district court in *State ex. Rel. Naylor v. Indiana State Teachers Assoc.*, 2010 WL 1737914 (S.D.Ind. Apr. 28, 2010) held that facts very similar to those

in the present case were sufficient to avoid a 12(b)(6) motion claiming the risk pool interests were not investment contracts. In *Naylor*, a trust was established to provide insurance products to teachers and school employees throughout Indiana and the teachers and school employees were entitled to the return of any monies paid to the trust in excess of claims paid, a situation very similar to LGC. In *Naylor*, the Indiana Securities Commissioner brought charges against the pooled risk entity for unregistered securities, unlicensed activity and fraud in the connection with the offer and sale of securities. The Indiana Securities Commissioner alleged that the entity failed to disclose substantial losses with their investments and did not have sufficient assets to meet obligations related to their insurance products. This analogous case is an important to point out as an example of how these risk pool contracts are considered securities and what could happen if a risk pool's investments are not monitored.

In addition, the Bureau recently learned through the New Hampshire legislative inquiry that LGC currently invests approximately eighty million dollars (\$80,000,000) with a third party money manager. With such a vast majority of LGC's reserves being invested with this third party money manager, determining whether these assets are appropriately valued on LGC's financial statements is extremely important to the Bureau and to the public. An overstated value of these assets would give the public a misconception of LGC's financial health. Also, the Bureau further believes that any profits gained from these investments must be considered surplus and returned to members, and the Bureau needs to trace this.

III. The Bureau Has the Enforcement Authority Under RSA § 421-B:22 and RSA § 5-B:4-a to Issue Investigative Subpoenas, Irrespective of Whether There is a Pending Proceeding.

The Bureau has many tools available when investigating those who may be violating New Hampshire securities law, RSA § 421-B. Specifically, pursuant to RSA § 421-B:22, II, "[f]or the purpose of any investigation, hearing or proceeding under this title, the secretary of state or any officer designated by him may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the secretary of state deems relevant or material to the inquiry." As the Bureau has alleged in the Staff Petition for Relief dated September 2, 2011 that LGC violated the securities registration

requirements of RSA § 421-B:11, the licensing requirements of RSA § 421-B:6, and the prohibition in RSA § 421-B:3 from making untrue statements or omissions of material fact in connection with the offer, sale or purchase of securities, the Bureau has the authority to issue investigative subpoenas in order to determine compliance with RSA § 421-B. Nowhere in the statute is there a limitation on these investigative powers after the initiation of an administrative action.

Pursuant to RSA § 5-B:4-a, "[f]or the purpose of any investigation, hearing, or proceeding under this chapter, the secretary of state or any officer designated by him or her may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the secretary of state deems relevant or material to the inquiry." Clearly RSA § 5-B:4-a gives the Bureau the authority to issue subpoenas for investigation or hearing purposes and nowhere in the statute is there a limitation on these investigative powers after the initiation of an administrative action.

IV. The Bureau Has the Visitorial Authority Under RSA § 421-B:9 to Conduct Special Audits and Inspections, Irrespective of Whether There is a Pending Proceeding

The Supreme Court of the United States has made clear that "a sovereign's visitorial powers and the powers to enforce the law are two different things." *Cuomo v. Clearing House Ass'n, LLC*, 129 S.Ct. 2710, 2717 (2009). The Bureau has visitorial powers pursuant to N.H. RSA § 421-B:9, where "[t]he records of a broker-dealer licensed or required to be licensed under this chapter, and of an investment adviser registered or required to be registered under this chapter, and of an issuer-dealer licensed or required to be licensed under this chapter *are subject to such reasonable periodic, special, or other audits or inspections* by a representative of the secretary of state, within or without this state, as the secretary of state considers necessary or appropriate in the public interest and for the protection of investors. An audit or inspection may be made *at any time and without prior notice*. The secretary of state may copy, and remove for audit or inspection, copies of all records the secretary of state reasonably considers necessary or appropriate to conduct the audit or inspection." (emphasis added).

As the Bureau has alleged in the Staff Petition for Relief dated September 2, 2011 that

LGC violated the securities registration requirements of RSA § 421-B:11, the licensing requirements of RSA § 421-B:6, and the prohibition in RSA § 421-B:3 from making untrue statements or omissions of material fact in connection with the offer, sale or purchase of securities, the Bureau has the authority to audit or inspect LGC to determine whether LGC is in compliance with RSA § 421-B. Understanding whether LGC violated any provisions of RSA § 421-B is certainly a matter of public interest and important for the protection of investors. This is especially true considering that LGC manages a pooled risk management program utilizing taxpayer monies for the benefit of political subdivisions of this state. Furthermore, nothing in the RSA § 421-B restricts this visitorial authority after the initiation of an administrative action. It is important to note that the hearing contemplated in RSA 421-B:9, V(b) deals simply with objections to the final filing of an examination report and is distinct from the process that leads to the kind of enforcement hearing currently being conducted by the Hearing Officer. RSA § 421-B:9, I, makes it very clear that an audit or inspection may be made at any time and without prior notice.

RSA § 421-B is clear, the Bureau may continue to investigate LGC and the Bureau has the visitorial authority to conduct an onsite examination of LGC, irrespective of whether or not there is a pending administrative action.

V. Other Jurisdictions Consistently Allow Securities Regulators to Continue Investigating After Initiating an Administrative Action

Other state and federal case law has clearly enforced the authority of securities regulators permitting continued investigation after the initiation of an administrative action.

In Sutro Bros. & Co. v. Securities and Exchange Commission, 199 F.Supp. 438 (S.D.N.Y. 1961), the issue before the United States District Court, Southern District of New York, was whether, during the pendency of a public proceeding, the investigative powers of the Securities and Exchange Commission ("SEC") are suspended with respect to the matters charged in the proceeding. In Sutro Bros. & Co., 199 F.Supp. at 439, the plaintiffs argued that the SEC may only gather further evidence of a pending proceeding by way of sworn testimony through accepted pretrial discovery methods like depositions and interrogatories. The court disagreed and stated that "[n]owhere in the Act do we find any limitation on this investigative power upon

the institution of an adjudicative hearing." *Id.* Furthermore, the court found that the decision of the SEC whether to continue its investigation was a decision "resting exclusively within the discretion of the Commission and not reviewable by a Court." *Id.* The court went on to explain that "[n]ot only may such an investigation reveal further evidence for use in the pending proceeding, but evidence of other violations which the Commission is charged by statute with the duty to investigate. The purpose of the statute would be severely frustrated were the power conferred on the Commission to be terminated by the institution of public proceedings against one of the alleged violators." *Id.*

In American Microtel, Inc. & Others v. The Secretary of State of the Commonwealth of Massachusetts, 1995 WL 809575 (Mass.Super. 1995), the Superior Court of Massachusetts decided that the Massachusetts Securities Division acted properly and pursuant to state securities law when it issued two investigatory subpoenas after an adjudicatory proceeding was initiated. The court disagreed with the plaintiff's argument that "such powers during an adjudicatory proceeding gives the Securities Division an unfair advantage over private litigants". Id at 10. The court further found that the Director of the Securities Division "properly utilized the powers conferred upon the Securities Division by statute." Id.

In *In re Ronald G. Sorrell*, 1981 WL 38135 (S.E.C. 1981), the SEC reviewed a decision by the National Association of Securities Dealers ("NASD"), which is a self-regulatory organization for broker-dealers in the securities industry, and found that the NASD acted properly when "secretly contacting" an individual involved in the case without notice to the respondent in a related administrative hearing. *Id.* at 4. The SEC confirmed that "the NASD was not required to suspend its investigation of this matter once hearings had begun." *Id.*

In *In re Federal Exploration, Inc*, No. 71,965. Blue Sky Reporter (Mass., 1984), the Massachusetts Securities Division, in an administrative hearing before them, found that the Division's enforcement staff may continue to investigate after the initiation of an enforcement action and further stated: "The complexity of the transactions involved in securities fraud cases means that avenues leading to critical evidence and further violations involving the pending matters or possible new parties often do not turn up until after an investigation has reached an advanced stage. To cut off the Division's investigative powers during adjudicatory proceedings would tie its hands and hamper its law enforcement responsibilities."

Not only have courts clearly upheld investigatory subpoenas after initiating adjudicatory

proceedings in the securities industry, but also in other regulatory contexts. *See, e.g. F.T.C. v. Browning,* 435 F.2d 96, 102-04 (D.C.Cir.1970) (upholding post-complaint subpoena power of the Federal Trade Commission); *Porter v. Mueller,* 156 F.2d 278, 279-80 (3rd Cir.1946) (upholding post-complaint subpoena power of Price Administrator under the Emergency Price Control Act of 1942); *Bowels v. Bay of New York Coal & Supply Corp.,* 152 F.2d 330, 331 (2nd Cir.1945) (same).

As the federal and state court decisions cited above have recognized, the Bureau respectfully requests that the Hearing Officer recognize the Bureau's continued investigatory authority under RSA § 421-B, even after the initiation of an administrative action. The purpose and policy of RSA § 421-B would be severely frustrated if construed otherwise and nowhere in the statute are the Bureau's investigatory powers limited after commencing an administrative action.

VI. The Bureau Has a Precedent Regarding the Issuing of Investigative Subpoenas and Conducting Special Audits After Initiating Administrative Actions

The Bureau has long held the position that it has the authority to continue issuing investigatory subpoenas, including under the caption of the pending case, and conducting onsite examinations after commencing an administrative action. Such a policy is essential to effective securities regulation in the state of New Hampshire. During the pendency of an administrative action, which in some cases can last well over a year, the Bureau still has enforcement and examination responsibility under law and must continue to investigate and examine these entities. To preclude the Bureau from continuing to investigate and examine entities that have pending actions would be detrimental to the people of New Hampshire and in contradiction with policies exercised by the Bureau in the past, as authorized by statute.

Historically, the Bureau has continued issuing administrative subpoenas while administrative actions were pending, including under the caption of the pending case. See, e.g. In re UBS Financial Services Inc., COM08-027 (N.H. Bur. Sec. Reg. August 22, 2011); In re: New Futures Trading International, I-2011000011 (N.H. Bur. Sec. Reg. October 4, 2011). Likewise, the Bureau also has a history of conducting targeted special examinations and audits after initiating an administrative action. See, e.g. In re Karl Hahn, INV-2010000015 (N.H. Bur.

Sec. Reg. October 18, 2011); In re Financial Resources and Assistance of the Lakes Region, Inc., INV00-007 (N.H. Bur. Sec. Reg. January 25, 2007).

The Hearing Officer should rule in accordance with the Bureau's precedent, preserve the public benefit of ongoing examinations and investigations, and allow the Bureau to continue issuing subpoenas and order an onsite examination of LGC.

VII. Under Modern Audit Procedures, An Onsite Examination of LGC is Required.

A review of the Bureau's request for an onsite examination shows that ordinary pre-trial discovery methods cannot efficiently provide the necessary information. If the Bureau were left with only pre-trial discovery methods, then the volume of documents that would be required and thus requested by the Bureau could amount to hundreds of thousands of pages. The Bureau would then need an extensive amount of time to process these documents and would then have to conduct several formal depositions in order to understand the financial documents requested and to understand the accounting practices of LGC. This would take several months. In the alternative, should the Hearing Officer order an onsite examination of LGC, then the Bureau could conduct an efficient examination of LGC that would eliminate the need for many depositions as well as the need for production of several hundred thousand pages of documents. Allowing an onsite examination of LGC would save this administrative process several months. which is a benefit to both the Bureau and the political subdivision members of LGC. The law allows for this audit and efficiency and public good demand it. Furthermore, the New Hampshire Supreme Court has already held in Prof'l Firefighter of N.H. v. HealthTrust, 151 N.H. 501, 504-505, that LGC is a quasi-public entity subject to the Right-to-Know Law, and since LGC holds hundreds of millions of dollars of taxpayer monies, public policy favors an onsite inspection of LGC.

VIII. Conclusion

It is clear that the Bureau has broad investigatory powers under RSA § 421-B when there is a reason to believe that a violation has occurred, that RSA § 5-B also provides broad investigatory powers, and there is no statutory language limiting this authority after the initiation

of an administrative action in either RSA § 421-B or RSA § 5-B. Construing the Bureau's authority otherwise would severely frustrate the purpose of RSA § 421-B and RSA § 5-B, would be contrary to Bureau precedent, and would drastically alter the Bureau's longstanding policy. It is likewise clear that, under RSA § 421-B, the Bureau has the authority to examine and audit entities when the Bureau believes they should be licensed under RSA § 421-B:6. Again, nothing in RSA § 421-B limits this visitorial authority.

Furthermore, it is clear that federal and other state securities authorities, acting under statutes containing very similar investigatory powers as those outlined in New Hampshire law, have held a similar view. Finally, both efficiency in this taxpayer funded process as well as LGC's quasi-governmental status call for the ordering of an onsite inspection.

For the foregoing reasons, the Bureau moves that the Hearings Officer grant the Bureau's Motion to Compel, Preserve, and Enforce Subpoena.

Dated this 29th day of November, 2011

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N.H. Bureau of Securities Regulation

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